DEBATE

Jean-Claude Trichet, former President, ECB

That was very stimulating and a magnificent conclusion, if I may, for the speakers. We will now have a lot of questions and I am sure that Jacob will have a lot of questions. Jim, you have the floor.

Jim Hoagland, Contributing Editor, The Washington Post

I wanted to join the chairman in describing Jacob Frenkel's presentation as absolutely smashing. I think that is exactly right. I wonder if you could outline for us the costs that you think are involved in living in this second-best world. There is obviously the cost of the repression of savings, but what does it do to the global economic financial functioning? Since John Lipsky mentioned the significant growth of sovereign debt as one of the features of this new era, I wonder if John would add a few words on how this growth of sovereign debt is affecting the financial functioning of the American economy in particular.

From the floor

Thank you very much. I have a question about the Eurozone and unconventional monetary policies for Professor Frenkel and Mr Coeuré. As we know, economic activity in the Eurozone is still very weak, especially in the south. That is an understatement. Credit activity is even weaker again in the south and the Eurozone is of course still exposed to any other shocks that we might not be able to foresee at this time, so I was wondering whether you could give us a sense of what the toolkit is that the ECB could exploit if the outlook does not materialise according to our expectations. For instance, Professor Frenkel was talking about forward guidance, but clearly the forward guidance that has been adopted and implemented by the ECB recently is quite different from the forward guidance that has been adopted by the Federal Reserve or the Bank of England. Likewise, the ECB's unconventional monetary policies might need to be a bit more targeted sectorally and geographically. I was wondering if you could give a sense of what might be feasible and whether you have any contingencies. Thank you.

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. Mr Giraud?

Renaud Girard, journalist, Le Figaro

Just because we are in a conference on global governance I would like to ask all of you gentlemen whether you think that the death of the fixed change Bretton Woods system, which died between the 15th August 1971 and the Jamaica agreement of 1976, is a major step backward in your field. For instance, in geopolitics and diplomacy the explosion of Yugoslavia is a regression, a step backward. Do you think it is a huge step backward or not?

Jean-Claude Trichet, former President, ECB

Thank you very much. The next question please.

From the floor

I have a very quick question that is very naive in a way. When we look at the securities that are purchased by the central bank, and particularly by the Federal Reserve as reported by Mr Frenkel, should we look at the outstanding debt of the United States by looking at the net figure or the gross figure because part of it is held by the Federal Reserve which is part of the US government.

Jean-Claude Trichet, former President, ECB

We will take one more question for the first batch of questions.

Gary Litman, US Chamber of Commerce

I am with the US Chamber of Commerce and we represent many multinational companies and mid-cap companies, many of which are not from the financial sector. Could I ask the panel to reflect what the treasuries of these organisations, of non-banking multinationals and larger companies, look for a couple of years from now given the changes in the banking sector and some of the macroeconomic issues that you have described? How should we prepare ourselves to deal with the new financial sector you are describing?

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. We have the first series of questions to be answered. I will give the floor first to Jacob if he wishes and then to other members, including you minister, if you like answering. Jacob, please take the floor.

Jacob Frenkel, Chairman, JPMorgan Chase International

I must say the questions were appropriate and very broad. The first question was what the cost is of being where we are. The fact that we discuss it now at 7.30 is one element of the cost. The cost is not focused and found in a specific point. It is dispersed and that is why there is a danger that we will not recognise it. However, I think we know that if it continues for a long time there will be lower growth out of that. The reason is that if you make an investment you ask yourself what the future will look like in order to decide what to do today. If you are told that where you are now is not sustainable but you do not know exactly where we can go to make it sustainable and when you go to make it sustainable, the typical instinct is to sit on your hands until the clouds go. However, if you sit on your hands for too long you will converge to a lower growth and that is why the concept of uncertainty is so dramatic. I use the word 'uncertainty' rather than 'risk' because it is unprecedented, so we cannot ask ourselves how the system reacted in the past for a similar thing. Because there is uncertainty we do not know the parameters of the distribution and we will sit on our hands. That is item one.

Item number two: we also know that the equilibrium of real interest rates in a growing economy must be positive because ultimately in equilibrium resources will be allocated so that they will have the same rate of return from all alternative risk-adjusted activities. If the tree gives me 5% fruit then the economy will not sustain negative 5% in the long term. We have population growth and growth of output. This is a distortion. Again, it converges to the same thing.

Item number three: ask yourself why it is the case that when we look at these unconventional measures, an extraordinary expansion of balance sheets, why the Brazilians, the Israelis, the Argentineans and those countries which suffered in the past from hyperinflation are more nervous than those countries that have somehow forgotten that prices can also go up rather than just down. This deflation phobia is not a long-term concern. I do not say that we currently have inflation risks, but it is definitely a possibility that is not being allowed for today by policymakers, markets or expectations. We know that, at least in the past, when these kind of things happened there was a possibility that it would not end well. I am unable to tell you that you should worry now about it, but it is an issue. Central banks mandates are usually always price stability, financial stability and so forth.

This brings me to the issue of mandates. When we talk about central banks we see that the US mandate is very different from the ECB's mandate. The US mandate, if you want to be cynical, is apple pie and motherhood and everything, in other words growth, standard of living, everything with this little simple instrument of monetary policy. That is why when the ECB was created there was a very well defined objective of price stability. There were secondary objectives, subordinate to the primary one, which would only be pursued if the main objective was not compromised. That is mainly what the central banks are doing in Europe. That is the mandate. More recently we have added financial stability, but it is already a complex issue because if financial stability is your goal it means that you are potentially schizophrenic. For price stability you want to tighten. For financial stability, if banks have weak balance sheets, you are afraid to tighten, which means that there is already an issue. You do not have enough instruments. This only underscores the importance of a robust financial system, robust banks, a lot of capital, high liquidity, low leverage, so that you can really address the main issues. However, that is the issue. When we talk about forward guidance therefore which objective are we trying to achieve? The US mandate or the ECB's mandate? We do not have yet have a convergence of mandates, let alone therefore operating in the same ocean like the capital markets. That is a major issue that we might get to.

As to the toolkit, we will not be able to invent new tools. Let us face that. For a while people said not to worry about zero interest rates because we have discovered macroprudential tools, as if they did not exist before. We have discovered forward guidance and open mouth policies, as if they did not exist before. They did exist before. They may not have been fully used, but let us face it: the main instrument of monetary policy is what monetary policy was always designed to produce. We know what that is. Regarding the toolkit therefore, implement the old tools. They will be good enough. Do not kid yourself that you have additional ones.

Jean-Claude used to tell us the story about the guy who was trying to get to Dublin but was lost in the middle of London, and he stopped somebody and asked, 'How do you get to Dublin?' and the guy told him, 'I do not know, but I would not start from here.' However, it is what it is. We are here and as we are here this discussion about a lack of purity will be part of the scene, but let us recognise that a lack of purity cannot be the aspiration of where we are.

I have one last remark about unintended consequences. As central banks, because of global responsibilities, stepped into territory where they would not normally have been there is the danger of politicisation or the perception of being part of the politic system, being under the pressure of governments. In the US Congress it is very clear that they said, 'You are now going into our territory and we will supervise you.' If we believe therefore that central bank independence, or I better call it independence from short-terms political pressures, is an important public good then we need to know that some of the unintended consequences in trying to help the system may be dangerous in the longer run.

Jean-Claude Trichet, former President, ECB

Thank you very much indeed, Jacob. We had implicit or explicit questions for the ECB. Perhaps Benoît wants to say something.

Benoît Coeuré, Member of the Executive Board, ECB

Yes, I am happy to say something. First, I would like to complement what Jacob said about the reimbursement on the long-term refinancing operations. It is true that there have been quite a lot of reimbursement. As of yesterday, 425 billion have been reimbursed, which is around 40% of the liquidity that had been provided. This is because a prepayment option was built into the mechanism. However, as Jacob said, first, it is a market process. This shows that those banks that had borrowed do not need the liquidity anymore from the ECB, meaning that they have access to other sources of liquidity. This is an indication that funding markets to a large extent all throughout Europe and banks have been able to issue bonds on capital markets. That is good news.

Second, there is one very important complement, which is that we provide weekly liquidity through fixed-rate full allotment, meaning that any bank that is in need of liquidity at any time, or on any Tuesday for that matter, can come to the ECB and they can borrow as much as they want provided of course that they are sound and have a good quality collateral. The LTRO repayment therefore does not hamper in any way the ability of Eurozone banks to access liquidity because we have this fixed-rate allotment that we have extended until July 2015. That was an important decision made in November. There is therefore no worry about the quantity of liquidity. That is one important clarification.

Secondly, as to what we can do, I think we have been clear that we have a range of options. We are willing and ready to act if needed. We do not feel that is needed now because we see inflation moving slowly back to 2% as the European economy recovers. That is the ECB staff forecast, which is pretty much the same forecast that you can find everywhere. It is consistent with the market consensus that the European economy will slowly recover and inflation will slowly come back towards 2%. However, we have instruments to use in case of need. We can have a negative deposit rate, which has been mentioned. We could cut rates a little bit further – not that much, but a little further – and we could have new liquidity operations if needed. However, as I said, the judgement is that it is not needed now, but we have a range of options.

Finally, on the mandate, the whole discussion on the different mandates is fascinating and a very important discussion, but in our case it does not matter so much in the current environment where the main issue facing the European economy is low growth with low inflation prospects, so we are entirely focused on our inflation mandate and this is what is needed by the European economy because we see low inflation and inflation only coming back slowly towards 2%. There is therefore no contradiction in any way between abiding strictly by our inflation mandate and supporting aggregate demand in the Eurozone. It is absolutely aligned.

It is true that there is no international convergence of central bank mandates, but still there has been convergence, and very significantly so in one aspect, which is a numerical definition of price stability, which all major central banks - Fed, BoE, BoJ - now as an inflation rate close to 2%. This is recent and it is quite remarkable that they have all somehow converged towards what the ECB had decided in 1998.

Jean-Claude Trichet, former President, ECB

I take your point. It has not been noticed too much that all major central banks of advanced economies have the same definition of price stability, namely 2%. This is quite new and not really noticed, but all of the currencies that are in the SDR have the same definition of price stability, which is 2%. Perhaps we could go now to Jeff.

Jeffrey Frieden, Professor of government, Harvard University

Sure. There was a question about Bretton Woods, looking backwards, and then one about the future, looking forward. As to Bretton Woods, no, its end was not a retrocession. I think it was necessary. The only way it could have been sustained was with massive capital controls and it probably would not have been sustained with that anyway because it persisted largely because financial markets were not particularly integrated at the time and economies were not that integrated. We live in a world in which financial markets are much more integrated and economies are much more integrated and that puts us in the world of the famous Mundell-Fleming conditions, or the so-called trilemma, where with financial integration really have a choice. They can have an independent monetary policy or they can have a fixed and stable exchange rate, but they cannot have both, and so countries have been driven towards one or the other. Small open economies have typically chosen stable exchange rates and given up their independent monetary policy and the big, more closed economies have chosen an independent monetary policy. However, Bretton Woods was not sustainable in the conditions then and it certainly would not be sustainable today without massive controls on capital and on financial flows and even on goods movements I would say.

Looking towards the future, I would say we have lived through a very bizarre decade and a half in which the engine of economic growth for one big group of countries was generating massive export surpluses and the engine of economic growth for another big group of countries was debt finance consumption and neither of those seems likely to continue because the appetite for the lending has dried up and the appetite for the borrowing has dried up even where it is possible. What I would look for is how these macroeconomic imbalances trend over the next several years, what the implications of that are for exchange rates and for relative prices. I think those are the big stories looking ahead to the remainder of the decade.

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. What would you say, John?

John Lipsky, Distinguished Visiting Scholar, The Paul H. Nitze School of Advanced International Studies

I would say it is impressive that after three hours we still feel like there are a lot of subjects that we have not explored adequately, but I will keep it very brief. In the big picture modern economies do not work well without well functioning financial systems and the financial systems in the advanced economies are not yet put back together from the crisis. Those places that have made the least progress in healing the financial system are doing the least well in terms of their economic performance. The use of QE was certainly an emergency response by central banks. I do not think there is anywhere, except possibly Japan, that folks think that QE is currently contributing positively to economic performance. Hence – perhaps I am a little more cynical – I look at forward guidance as a nifty way to change the subject and to get away from QE and have something new to talk about, although I cannot quite see how current boards of central banks can commit future boards of central banks to do anything in particular, but it is okay.

Regarding the US sovereign debt, I think it is worth taking a step back. Pre-crisis, for about 50 years, US federal spending as a percent of GDP was broadly stable and the variability was mainly cyclical, not political. The same applies to revenues, with an average deficit, excepting emergencies, wars and so forth, of around 3% of GDP with real growth at about 3.75% of GDP. In normal times therefore US fiscal accounts tended to reduce debt as a percent of GDP. They have now gone to another level and we have of course seen a reduction in the deficit from about 10% of GDP at the peak. It is going to be under 4% of GDP in the coming year for sure, but what we cannot do is look forward to a re-establishment over a long period of time of this prior tendency towards stability or a reduction of debt as a percent of GDP. It is not going to be happen very soon because it will require both tax reform and entitlement reform. That is what is necessary for that kind of stability to be established.

For now, it is clear, because of the very low rate of interest on sovereign debt, that it is not getting in the way of the performance of the economy. However, as Jacob was hinting, you cannot simply take that for granted forever, and I would say that the status quo ante was a tendency for control over debt to GDP and we cannot look forward to that without new action. As to net debt versus gross debt, I think it depends on what question you are asking, but I think in terms of the question you are asking I would probably look at net debt more than gross debt. However, both can be important.

What is the financial sector going to look like in the future? It is going to be more market based and less bank-centric. It is going to be less liquid. I worry that it is going to be a little less efficient. It will be interesting to see where things are going. The US is 20/80 or maybe even less than 20 and more than 80. Europe is 80/20. I think the conventional wisdom is that it has got to go not all the way to the US but somewhere in that direction. It will be interesting to see.

I have one quick comment on Bretton Woods. What Jeffrey said was very good. At the time Bretton Woods broke up the conventional wisdom of the academics and others was that this was going to be a positive move to creating more efficiency and greater stability and it turned into the reverse, i.e. immediately high inflation and big imbalances. I think it was not just the breakup of the system but the fact that the financial system was absolutely in no condition to provide the stabilisation that markets can provide. Hopefully we are closer to there now, but in the current conditions – and this harkens back to something Il SaKong said – the ultimate guarantee of stability is the consistency and coherency of macroeconomic policy of the major economies and that is something the G20 set out to try to establish in a much more convincing way and I worry a lot that the political impetus and senior level political support for that process, the framework for strong sustainable and balanced growth, seems to be wasting away.

Jean-Claude Trichet, former President, ECB

Thank you very much indeed. I see no hands raised. I think we have worked very, very well. I was not expecting that we would be eager to continue. Let me just say two words. First, global governance now means full involvement of all emerging economies that are systemic. It is entirely new. It is the product of the crisis. Before the crisis it was not the case. We already had some kind of G20 or whatever. It was not considered to be the main informal grouping for running the global economy. We must be aware of that. There have been positives and negatives, as you said. We are not satisfied at all. There is a lot of frustration, but nevertheless, that is something which is for real and will last I hope.

Second, on the euro, we did not concentrate at all on the euro, but let me tell you the following. You hear very often that we do things to save the euro and that the euro needs to be saved. The euro is behaving pretty well I have to say. During the entire crisis, which has been the worst crisis since World War II and perhaps could have been the worst since World War I, the level of the euro/dollar was higher than the entry level as of the 1st January 1999. The markets, investors and savers the world over therefore had full confidence in the euro. Even Mr Giraud knows that when he meets colleagues here it is said that the euro is too strong, the euro inspires too much confidence and the euro is capturing too many investors and savers. The problem is therefore not the euro. The euro as a currency is very credible. The problem is preserving the integrity of the euro area and for political men and women it is a little bit more complicated to say we do that to preserve the integrity of the euro area instead of saying we do it to save the euro.

However, that being said, I have to say I am amazed, having been at the heart of this turmoil, to see that not only all of the countries that were in the euro area remain in the euro area, including Greece, but that we have added three counties to the euro area since Lehman Brothers. Slovakia entered after Lehman Brothers. Estonia entered after Lehman Brothers and Latvia will enter in a few days. That is the reality. These are the facts and this is something which is so bizarre, so out of the global communication, that it is hard to believe.

My last remark echoes what Jacob so eloquently said. The central banks are now in a very narrow path between inflation and deflation, between the collapse of the financial system, which is still not working well in all of the large advanced economies, and that is an immense challenge for all of us and all of them, and, on the other hand, there is the financing of the treasuries, which becomes something which is quite impressive and is potentially inflationary, when the collapse of the financial system would be potentially deflationary. That is the reason I was mentioning a narrow path. There is another narrow path, if I may, which was already mentioned by Jacob. It is: are you sure that you are doing what you have to do to prevent catastrophe? Okay, that is good. You have to prevent catastrophe. However, do you do too much and lead to the other partners not doing their job. If governments, on the one hand, and the private sector, on the other hand, do not do their job we will be paving the way for the next catastrophe in the future, so there is reason to be particularly tranquil in the present situation.

It was a fantastic afternoon.